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¶1. (SBU) Summary. Ukraine's banking sector troubles are among the IMF and World Bank's foremost concerns amidst a deepening financial crisis. Short of liquidity and with worsening loan performance by the day, banks are awaiting a decision by the National Bank of Ukraine (NBU) and the GOU on a framework mechanism for recapitalization and resolution. The NBU has not announced how much additional capital the largest 17 banks will need, but reports indicate that it might be less than originally anticipated. The NBU has sent signals this week that it is willing to accept a proposal from the IMF and World Bank on a framework, though concrete measures to establish a Recapitalization Board and a Problem Bank Unit have nonetheless stalled.

¶2. (SBU) In the meantime, Ukraine's domestic banks are facing the greatest troubles, causing the World Bank to worry about the adequacy of Ukraine's deposit insurance program. Subsidiaries of foreign banks are making their own plans to roll over debt coming due this year and infuse banks with whatever additional capital the NBU will require. The liquidity shortages have spawned a parallel market for dollars and hurt everyday citizen depositors, who tell us they cannot withdraw foreign exchange and also face strict limits on access to hryvnia (UAH) deposits. End summary.

Recapitalization Urgent

¶3. (SBU) The NBU completed diagnostic audits for Ukraine's seventeen largest banks on January 22 (Ref A). Although the NBU Board has yet to announce which banks will need additional capital, the sum may be less than originally foreseen. As of December, it was expected banks might need up to $10 billion, however, press reports quote the NBU's Oleksander Kiriyev, Executive Director for Banking Regulation and Supervision, as saying (during the meeting mentioned in Ref A) that the 17 largest banks will need an additional $3.08 billion in capital. Foreign banks will require an additional $1.8 billion, Ukrainian private banks $900 million, and the two state-owned banks $350 million, in addition to the $1.875 billion injection they received in late 2008. Although most, if not all, of the 17 will need to account for worsening loan portfolios and higher capital requirements, it now appears that foreign banks are prepared to provide whatever additional capital their Ukrainian subsidiaries need in full (Ref B). It is unclear whether Ukrainian banks will get the needed capital injections from their shareholders, or through a still

undetermined process that will likely be jointly governed by the NBU and GOU. Auditors mandated by the NBU have now begun to review the next 17 largest banks. Their results are expected in late February.

¶4. (SBU) During a January 30 coordination meeting of technical assistance donors, Lalit Raina, the World Bank's Washington-based financial sector manager for Eastern Europe and Central Asia, pointed out another challenge facing the banking sector: the Deposit Insurance Fund (DIF) may not have sufficient funds to cover deposits at banks that are liquidated. Insurable deposits in Ukraine's banking system total UAH 126 billion ($15.75 billion), but the DIF only has UAH 3.5 billion ($437 million) in cash and securities on hand. The DIF has identified 23 banks that it believes are particularly at risk; these banks have UAH 22 billion ($2.75 billion) of insurable deposits, or roughly seven times the DIF's funds. Raina observed, however, that the UAH 44 billion ($5.5 billion) line item in the 2009 budget foreseen for bank recapitalization and resolution could also be used, at least partially, to cover deposits for banks that the NBU has taken under temporary administration. The DIF would only be called to task after a bank's license was revoked, but the budgetary money could conceivably help cover deposits in banks that remained only under temporary administration. Using funds for this purpose would reduce the amount available for recapitalization, of course. He continued, "There are real risks. Time is running out. Banks will fail. But there is no courage or will to create laws to put a 'ring fence' around bad banks."

Bank Resolution Framework

¶5. (SBU) The IMF and World Bank have worked together with Department of Treasury experts to propose a basic framework for problem bank resolution. The proposed framework would establish a high-level board to oversee all bank resolution efforts, a Problem Bank Unit (PBU) under the NBU Board to manage the provisional administration of failing banks, and a bridge bank under the PBU to merge or absorb banks through purchase and assumption transactions.

¶6. (SBU) The NBU has yet to table a suggestion of its own, but Kiriyev has told Treasury, World Bank, and IMF officials that the NBU is open to the donors' proposed framework. Kiriyev has been under intense pressure from the IMF and World Bank to prepare a response to Ukraine's growing banking crisis.

¶7. (SBU) The IMF's financial sector experts told us on February 4 that they still do not even know where or how the NBU and/or the Ukrainian government would oversee the recapitalization and liquidation process, nor could they say for certain which legal and regulatory measures were being pushed in parliament. On February 2, director of the Institute for Economics and Forecasting at the National Academy of Sciences Valeriy Heyets told us that a legislated framework for recapitalization and liquidation will be difficult to achieve. "There is so much lack of faith in the Rada, and in the GOU and NBU right now. No one believes that politicians and their kind will look after the common good." (Note: The Verkhovna Rada is expected to review legislation related to the economic crisis during its plenary session on February 5. End note.)

¶8. (SBU) A fully staffed IMF team, in Kyiv to review the Fund's 16.4 billion Stand-By Arrangement, warned on February 4 that Ukraine is facing serious problems implementing its conditionalities. Flying in from Washington to assist the review team, the IMF's European Department director Marek Belka said his visit was

"exceptional," insinuating that Ukraine may fail to qualify for its second tranche of roughly $2.5 billion, due to be disbursed in late March.

European Banking Exposure

¶9. (SBU) Foreign bankers and diplomats have told us they expect foreign banks to provide additional capital needed for their Ukrainian subsidiaries. Francesco Giordano, chief of strategy at UniCredit in Ukraine, told us that his parent bank is fully committed to rolling over short-term debt. (Note: UniCredit's exposure to Ukraine is run out of its Vienna-based subsidiary Bank Austria.) He also said that the bank has made a strategic decision to refinance even poor performing loans on the verge of default, since collateral or repossessed assets also have falling market value. "We are taking the long view -- even 50 years," he said, referring to UniCredit's strategy to help its customers stay financially solvent, although it means "they have (UniCredit) over a barrel right now."

¶10. (SBU) Reading the pulse of European bankers, a well-informed Austrian embassy commercial attache Clemens Machal told us on February 3 that "Ukraine is too big to fail" and that European parent banks would remain fully committed to their Ukrainian subsidiaries. Although Austrian bank exposure in Central and Eastern Europe equates to roughly 100 percent of Austria's total GDP, the Austrian government was comfortable that its banks had the strength to weather the crisis. As a result, Vienna sees itself as a leader in European diplomatic efforts to reduce the risks of the European banking sector in the region. Specifically mentioning Erste Bank, UniCredit, and Raiffeisen Aval, Machal stated that Austrian banks had previously pursued conservative strategies, were not hard hit by the U.S. subprime crisis, and still possessed enough liquidity to roll over short-term debt and increase capital. The Austrian diplomat acknowledged that the Ukrainian banking sector and the economy more broadly were European problems, adding "no one seriously expects" the U.S. government to "bail out" Kyiv.

Banks Failing Depositors

¶11. (SBU) Anecdotes abound about bank clients who have been denied access to personal cash accounts, or who have had to accept piecemeal withdrawals of mature term deposits. We have heard that holders of dollar and euro accounts cannot receive foreign exchange, and instead must rely on hryvnia withdrawals converted at the official NBU exchange rate, which is significantly lower than interbank rates or cash rates in Kyiv's currency kiosks. One embassy source told us that euros earned in Estonia and subsequently wired to a business account in Ukraine could not be accessed, even though he had a valid foreign exchange claim against the bank. This is a worsening of the situation from a few weeks ago, when short-term dollar account holders could still retrieve at least partial funds.

¶12. (SBU) Demand for dollars remains ferocious, and even though the banks and kiosks quote prices at which they would sell dollars, it is nearly impossible to actually obtain foreign exchange by these means. Others have stepped in to fill this gap. Econoff went to a department store in central Ukraine to witness old ladies in heavy jackets selling dollars to a variety of clients. It is an open secret that even though the rate for dollars on the street corner has exceeded the official NBU rate by 20 percent, the ladies are a steady source of dollars, so much so that they had to ward off customers to minimize attention to their operation.

¶13. (SBU) Citizens on the street have also relayed stories of a hryvnia liquidity shortage, as the NBU has pursued a policy of tightened money supply to clamp down on exchange rate volatility. Local banks, in turn, have limited withdrawals or stopped them altogether. We have heard that banks are failing to honor maturing term deposits that had been established in recent months by customers attracted to handsome interest rates for both foreign exchange and hryvnia. One contact told us that she was only able to withdraw roughly UAH 500 ($65) of her maturing UAH 12,000 ($1,500) term deposit on a daily basis, forcing her to stand in long lines with other account holders during lunch breaks or after work. Queues can be seen at various Ukrainian banks around Kyiv, notably at Nadra Bank, which has had an on-again/off-again relationship to energy tycoon Dmitry Firtash (Ref C) but is now under NBU administration. Concerns about runs on these banks are growing, especially since the banks themselves only allow a certain amount of daily withdrawals before closing teller services.

¶14. (SBU) Comment. The growing panic among depositors reflects real public anxieties about Ukraine's troubled banks, as well as exasperation among foreign donors, who are standing by with concrete suggestions on how to reconstitute Ukraine's banking sector oversight bodies and implement a much-needed recapitalization and liquidation program. The IMF has upped the ante, bringing in its lead for European operations to press for adherence to the Fund's conditionalities. The consequences of inaction for domestic banks are severe, particularly if the queues we have observed persist in the coming days. All eyes are on a headless NBU (absent Governor Stelmakh, who has been on a month-long "vacation"), a leaderless Ministry of Finance (absent Minister Pynzenyk, who is "hospitalized"), as well as on the divided Rada, to come up with an immediate solution. End comment.

TAYLOR